1996

Real estate industry developments - 1996/97; Audit risk alerts

American Institute of Certified Public Accountants

Audit Risk Alerts

Real Estate Industry Developments—1996/97

AICPA

American Institute of Certified Public Accountants

NOTICE TO READERS

This Audit Risk Alert is intended to provide auditors of financial statements of real estate enterprises with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Richard Stuart
Technical Manager
Accounting Standards Division

The staff of the AICPA gratefully acknowledges the contribution of the AICPA Real Estate Committee to this document.

1 2 3 4 5 6 7 8 9 0 AAG 9 9 8 7 6

Table of Contents

Page

Real Estate Industry Developments—1996/97

Industry and Economic Developments

In last year's *Real Estate Industry Developments*, it was noted that the state of uncertainty that had existed in the real estate industry continued. That state continues to exist in 1996, as investors, having suffered through a prolonged recession in the industry, continue to display hesitancy despite improvement in many indicators.

Positive trends related to vacancy rates and housing starts continue to emerge, but there are variances by region and property type. Auditors should be aware of the risks relevant to the property type and geographical region(s) in which their clients operate (and not just where the clients' headquarters are located).

In the 1980s and early 1990s, the commercial markets experienced an oversupply of space. The primary factors contributing to the oversupply were the overbuilding of the 1980s combined with the general economic recession, a trend towards corporate downsizing, and the changing demographics of many entities. As the industry began to suffer the results of the oversupply, new construction slowed drastically.

Over the past several years, the demand for commercial space has been improving. However, much of that demand has been met by space that was already available, and no more than a limited level of new construction has been required. As vacancy rates continue to decline, and capital continues its slow return to the real estate market (albeit from new sources, as discussed later), indications are that new construction is picking up. Although many observers feel that the industry will not return to the exaggerated overbuilding of several years ago, concern does exist that the industry may overreact.

In the residential market, demand for houses continues to be linked to mortgage rates. Mortgage rates continue to be low compared to recent historical rates. However, any future increases in interest rates would have an adverse impact on housing demand.

Throughout the early 1990s, the real estate industry experienced a marked increase in the formation of real estate investment trusts (REITs). For owners and developers, REITs provide an alternative method of raising capital in tight credit markets (which existed for the real estate industry during the early 1990s). For investors, REITs offer a securitized investment that may be an attractive vehicle for increasing investment yields. As discussed in the "Audit Issues and Developments" section of this Audit Risk Alert, auditors should be aware of recent developments in the REIT marketplace that may indicate going-concern or asset-valuation issues.

While capital has begun to return to the market, the sources of that capital have changed. Although the traditional investors such as banks, pension funds, and life insurance companies remain the major sources of capital, alternative sources, primarily REITs and issuers of collateralized mortgage-backed securities (CMBSs), have increased in significance. Some of the largest real estate capital providers have been converting debt assets into debt securities, providing an efficient way for real estate to be financed. Securitization of real estate continues to increase. A record level of CMBS issuance is expected this year.

The current securitization activity continues an upswing that started when the Resolution Trust Company (RTC) needed to dispose of large numbers of mortgages as quickly as possible. The return of capital is likely to accelerate now that legislation related to Financial Asset Securitization Investment Trusts (FASITs) has been passed. FASITs, with less restrictive qualification and operational requirements than Real Estate Mortgage Investment Conduits (REMICs), likely will increase the credit availability to most market segments, particularly small businesses and developers. Unlike a REMIC, a FASIT is permitted to increase or decrease its asset pool after the assets have been placed in the portfolio. As a result, construction financing will qualify for securitization, making financing more available to real estate developers. Although passage of the FASIT legislation is viewed as a positive development for the industry, some concerns exist that the increased availability of financing may lead to a return to overbuilding.

Also contributing to the fear of overbuilding is the increased availability of credit already existing in some markets, even before the September 1, 1997 effective date of the FASIT legislation. Lending activity has increased in response to the slow upward trend in real estate values. As a result of the increased lending, construction activity in some markets has begun to pick up, which also contributes to the fears of overbuilding.

Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), as amended, requires that in planning their audits, auditors consider matters that affect the industry in which the entity operates, such as the economic factors. With respect to audits of real estate entities, this would include the commercial and residential markets described above.

Regulatory Matters

Real estate entities and the transactions in which they engage have become the focus of an increasing level of government regulation. SAS No. 22 requires that in planning their audits, auditors should obtain a knowledge of matters that relate to the entities' business, including, among other things, government regulations. Auditors should consider such regulations in light of their potential effect on the financial statements being audited. SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards,* vol. 1, AU sec. 317), requires auditors to design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts. An audit performed in accordance with generally accepted auditing standards (GAAS) normally does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred.

Specific laws and regulations that may affect the real estate industry are discussed in the following paragraphs.

Private Securities Litigation Reform Act of 1995

In December of 1995, the Congress passed over the President's veto the Private Securities Litigation Reform Act of 1995. One important aspect of this legislation is the inclusion of Section 10A into the Securities Exchange Act of 1934. Section 10A codifies certain professional auditing standards, provides a broad definition for "illegal acts," and expands the obligations of auditors to timely report certain uncorrected illegal acts.

New Section 10A codifies existing auditing standards in four areas. It requires auditors to identify illegal acts (which is currently required by SAS No. 54), identify related parties (which is currently required by SAS No. 45[1]), and evaluate whether substantial doubt exists about an entity's ability to continue as a going concern (which is currently required by SAS No. 59[2], as amended by SAS No. 64[3] and

[1] *Omnibus Statement on Auditing Standards*—(AICPA, *Professional Standards,* vol. 1, AU secs. 313, 334, and 557).

[2] *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards,* vol. 1, AU sec. 341).

[3] *Omnibus Statement on Auditing Standards—1990* (AICPA, *Professional Standards,* vol. 1, secs. 341, 508, 543).

SAS No.77 [4]). Section 10A also codifies and expands the auditor's responsibility to report illegal acts pursuant to SAS No. 53[5].

Auditors should note that Section 10A broadly defines "illegal acts" to include "an act or omission that violates any law, or any rule or regulation having the force of law." This definition is especially significant when it is considered in relation to the specific determinations an auditor must make and the expanded responsibilities of auditors to timely report certain uncorrected illegal acts.

For example, Section 10A specifies that when the auditor becomes aware of information indicating that an illegal act may have occurred, regardless of the perceived impact of the illegal act on the issuer's financial statements, the auditor must make certain determinations. The auditor must (1) determine whether it is likely that an illegal act has occurred; (2) if so, determine the possible effects (including any contingent fines, penalties, and damages) on the issuer's financial statements; and (3) as soon as practicable, inform management of the illegal act(s) and assure the issuer's Board of Directors is also adequately informed of such act(s) (unless the illegal act is clearly inconsequential).

However, the auditor's responsibility is expanded beyond the present guidance under GAAS to include the requirement that auditors report to the issuer's Board of Directors the auditor's belief that the illegal act has a material effect on the financial statements of the issuer, senior management has not taken "timely and appropriate remedial actions with respect to the illegal act," and the auditor reasonably expects the failure to take remedial action will result in the issuance of a non-standard report or the auditor's resignation from the audit engagement.

Once auditors report to the Board of Directors that appropriate remedial actions have been taken, an issuer must inform the SEC of the auditor's conclusions within one business day of receiving the auditor's report. If the issuer fails to inform the SEC, the auditor is required to notify the SEC within one business day. Section 10A, through the Exchange Act, provides for the imposition of penalties of up to $500,000 on auditors for willful failure to comply with the reporting responsibilities created by Section 10A.

The SEC has proposed a rule to implement the reporting requirements set forth in Section 10A with a deadline for comments of October

[4] *Amendments to Statements on Auditing Standards No. 22,* Planning and Supervision, *No. 59,* The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, *and No. 62,* Special Reports (AICPA, *Professional Standards,* vol. 1, AU secs. 311, 341, 544, and 623).

[5] *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, *Professional Standards,* vol. 1, AU sec. 316).

28, 1996. The proposed rule would specify, among other things, that registrants and auditors should submit any notice or report required by Section 10A in a written, confidential communication rather than on a public disclosure form, that the SEC's Office of the Chief Accountant should receive the report, that the report should include information identifying the issuer and the auditor, and that the report would be exempt from the Freedom of Information Act to the same extent as SEC investigative records. In addition, practitioners should be aware that neither Section 10A nor the release alters existing auditor reporting requirements.

U.S. Department of Housing and Urban Development Regulations

Through the Federal Housing Administration (FHA), the U.S. Department of Housing and Urban Development (HUD) regulates the development and operation of all of the housing projects for which it insures mortgages or provides rent subsidies. Entities that receive financial assistance from HUD are required to submit audited financial statements to HUD annually. Those audits are required to be performed in accordance with GAAS, Government Auditing Standards (GAS; also commonly referred to as the "Yellow Book") issued by the Comptroller General of the United States, and the Consolidated Audit Guide for Audits of HUD Programs, issued by the HUD Office of the Inspector General (OIG).

Before accepting HUD audits, auditors should be aware of the HUD oversight program. Representatives of HUD have the ability to review workpapers of individual engagements. If HUD determines that the audit is not in compliance with the HUD audit program, the individual (rather than the firm) that performed the audit can be banned from performing future HUD audits. Furthermore, HUD might refer the matter to the individual's state board of accountancy.

Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance

Because real estate entities may be recipients of governmental assistance, auditors should consider the guidance in AICPA SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards,* vol. 1, AU sec. 801). SAS No. 74, which supersedes SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance,* is effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994. SAS No. 74 provides general guidance to practitioners engaged to perform compliance audits of recipients of governmental financial assistance.

SAS No. 74 continues to recognize three levels of audits—GAAS, *Government Auditing Standards,* and certain other federal requirements—of recipients of governmental financial assistance. SAS No. 74 is applicable when the auditor is engaged to perform an audit of a governmental entity under GAAS, an audit under *Government Auditing Standards,* or in certain other circumstances involving governmental financial assistance, such as single or organization-wide audits or program-specific audits under certain federal or state audit regulations.

SAS No. 74 provides general guidance to the auditor on the:

1. Application of the provisions of SAS No. 54, relative to detecting misstatements resulting from illegal acts related to laws and regulations that have a direct and material effect on the determination of financial statement amounts in audits of the financial statements of governmental entities and other recipients of governmental financial assistance.
2. Performance of a financial audit in accordance with *Government Auditing Standards.*
3. Performance of a single or organization-wide audit or a program-specific audit in accordance with federal audit requirements.
4. Communication with management if the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of his or her engagement.

Interstate Land Sales and Full Disclosure Act

Developers are required to make full disclosure in connection with the sale or lease of certain undeveloped subdivided land. The Interstate Land Sales and Full Disclosure Act (the Act) makes it unlawful for a developer to sell or lease, by use of the mail or any other means of interstate commerce, any land offered as part of a common promotional plan unless the land is registered with the Office of Interstate Land Sales Registration. The Act requires that a printed property report be furnished to all prospective purchasers or lessees. Similarly, the Federal Trade Commission has the authority to act on unfair or deceptive trade practices with respect to real estate sales, particularly as they relate to the marketing and selling activities of real estate companies. See the discussion on SAS No. 22 and SAS No. 54 in the "Regulatory Developments" section of this Audit Risk Alert.

Regulation Z of the Consumer Credit Protection Act

Because most real estate purchases are made on credit, truth-in-lending laws can have a significant effect on real estate financing transactions. Regulation Z of the Consumer Credit Protection Act prescribes requirements for both creditors and borrowers for full disclosure of credit costs that are applicable to all real estate transactions, regardless of amount, in which individual borrowers are involved in nonbusiness transactions. Failure to comply could be considered an illegal act that has an indirect effect on the financial statements.

Tax Matters

Many real estate transactions such as "synthetic" leases or formation of an umbrella partnership REIT (UPREIT) or a DownREIT are structured to achieve specific tax purposes. Each of these transactions is discussed below. Further discussion of accounting topics relevant to these types of transactions is included in the "Accounting Developments" section of this Audit Risk Alert.

UPREITs. In the formation of a typical UPREIT, an operating partnership is formed by a sponsor. The sponsor contributes real estate properties and related debt to the operating partnership. The exchange typically is accounted for as a reorganization of entities under common control in a manner similar to a pooling of interests. Concurrent with the formation of the operating partnership, a REIT invests proceeds from a public offering in exchange for a majority interest (general partner) in the operating partnership; the sponsor retains a minority interest in the operating partnership. Because of its controlling financial interest, the REIT consolidates the operating partnership in its financial statements. In the typical UPREIT structure, the REIT's consolidated financial statements report the assets and liabilities contributed by the sponsor at the sponsor's historical cost basis. One of the reasons for the popularity of the UPREIT conversion is that the seller can defer tax by accepting operating partnership units as consideration.

DownREITs. In the formation of a typical DownREIT, an existing REIT forms an operating partnership with the property owners of the desired acquisition property, generally with the existing REIT as the general partner. The owner contributes the assets to the operating partnership and, in return, receives partnership units that can be exchanged at some future date for shares of stock in the REIT. Similar to UPREITs, one of the benefits of a DownREIT structure is that the seller can defer tax by accepting partnership units as consideration. Additionally, the DownREIT structure is easier to implement than an UPREIT conversion.

Synthetic Leases. The use of synthetic leases is becoming more common in the real estate industry. Use of a synthetic lease allows the lessee to obtain financing while permitting off-balance sheet treatment for the related obligation and asset. Establishment of a typical synthetic lease might include the following steps:

- A nonconsolidated special purpose entity (SPE) would be established to act as the lessor of the property in question.
- The lessee would sign a lease under which the monthly net rental payments would cover the SPE-lessor's debt service.
- The SPE-lessor would obtain nonrecourse financing to be used to obtain the property, using the lease as security.

The lease agreement would be structured so that upon expiration, the lessee would have the option of renewing the lease, purchasing the property, or causing the property to be sold. If the property is sold for an amount greater than the SPE-lessor's investment, the lessee would retain the excess. If the sales proceeds do not cover the SPE-lessor's investment, the lessee would be required to make a contingent rental payment to the SPE-lessor in the amount of the shortfall, subject to the limitation of the residual value guarantee. The present value of the minimum lease payments (base rental payments plus the residual value guarantee) to the SPE-lessor must be less than 90 percent of the original cost of the property, or capital lease treatment would result.

One reason a lessee might wish to use a synthetic lease is that such an arrangement permits the lessee to use off-balance sheet treatment for the asset and obligation, yet retain the benefit of any appreciation in the property during the lease term. Additionally, because the lessee will be considered the owner of the property for tax purposes, the lessee will be entitled to claim deductions for interest on the debt and tax depreciation on the property.

Auditors should be aware that the accounting literature covering synthetic leases, including Financial Accounting Standards Board (FASB) Emerging Issue Task Force (EITF) Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions," and EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities," is complex, and failure to comply with all of the requirements could result in material misstatement of the financial statements.

Auditors also should be aware that the use of synthetic leases, UPREITs, DownREITs, or similar strategies may affect audit risk. If structured incorrectly, these types of transactions or arrangements may have significant adverse impact on the financial statements of clients. For example, one of the main reasons to use synthetic leases is the ability to retain off-balance sheet treatment for the related asset. However, if the synthetic lease is structured incorrectly, the entity may be required to consolidate the SPE that was formed to act as the lessor of the property. This would defeat the purpose of the synthetic lease structure.

Audit Issues and Developments

General Risk Factors

Although conditions vary from region to region and entity to entity, general factors inherent in the real estate industry that influence audit risk include the following.

Magnitude and Complexity of Transactions. The financial statements of real estate companies generally include a large number of highly complex transactions. The complexity of these transactions is increased by the fact that a number of them are based on estimates.

Lengthy Development or Holding Periods. By their nature, real estate projects involving construction require significant lead time. Delays may result in increased costs and potentially affect the accounting for the assets being constructed. See the section entitled "Asset Impairment".

Financing and Liquidity Concerns. Real estate enterprises are often highly leveraged, creating concerns about the ability of entities in the industry to continue to obtain adequate capital and to meet obligations as they come due. Auditors should carefully consider these industry-specific conditions and assess the effect they have on audit risk.

Asset Impairment

Impairment of assets continues to be a major concern throughout the real estate industry and requires critical attention in the audits of financial statements of real estate entities. FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text*, vol. 1, sec. I08), which is effective for financial statements for fiscal years beginning after December 15, 1995, has particular importance in the real estate industry. As discussed in the "Accounting Developments" section of this Audit Risk Alert, FASB Statement No. 121 revises significantly the way in which entities will account for real estate. It requires different accounting for impaired assets based on whether those impaired assets are "to be held and used" or "to be disposed of."

Auditors should obtain reasonable assurance that management has considered all relevant factors in determining whether asset impairment has occurred. The subjectivity of determining the adequacy of the impairment adjustment reinforces the need for careful planning and execution of audit procedures in this area.

Conditions or events such as the following may indicate a need for assessing the recoverability of investments in real estate:

- Cash flows from operating activities are insufficient to cover debt service.
- Current occupancy rates indicate that future cash flows to be received are lower than the amounts needed to fully recover the carrying amount of the investment.
- Major tenants have experienced or are experiencing financial difficulties.
- A significant portion of leases will expire in the near term.
- Lessors are being forced to make significant concessions in order to rent property.
- Properties held for sale remain unsold at subsequent balance sheet dates.
- Other investors have decided to cease providing support or to reduce their financial commitment to a project or venture.
- Rental demand for a rental project currently under construction is not meeting projections.
- Auditors' reports on financial statements of investee properties are modified for reasons that relate to real estate investments. For example, an auditor's report on the financial statements of investee properties is modified for a departure from generally accepted accounting principles (GAAP) due to improper valuation of assets.

Lack of an asset-impairment evaluation system may indicate a material weakness in the entity's internal control structure. Further, a lack of documentation generally will increase the extent to which judgment must be applied by auditors in evaluating the adequacy of management's writedowns and will increase the likelihood that differences will result. The AICPA Audit and Accounting Guide *Guide for the Use* *of Real Estate Appraisal Information* provides guidance to help auditors understand real-estate appraisal concepts and information. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards,* vol. 1, AU sec. 342), should be followed in auditing estimates such as impairments.

Auditors also should consider the propriety of the client's classification of assets as "held for sale" or "held for investment." Land to be developed and projects under development should be accounted for in accordance with paragraphs 4 through 7 of FASB Statement No. 121 (that is, they should be considered "assets to be held and used"). Completed projects that the entity intends to dispose of should be accounted for in accordance with paragraphs 15 through 17 of the Statement ("assets to be disposed of").

SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards,* vol. 1, AU sec. 336), provides guidance on auditing internal or external appraisals of real estate.

Real Estate Properties Held for Investment. Real estate held for investment should be reported at cost, less accumulated depreciation, and should be evaluated for impairment if facts and circumstances indicate that impairment may have occurred, in conformity with the provisions of paragraphs 4 through 7 of FASB Statement No. 121. If events or changes in circumstances indicate that impairment may exist, the entity is required to estimate the future cash flows expected to result from the use of the asset and its eventual disposition.

An impairment is deemed to have occurred if the carrying amount of the asset exceeds the sum of the expected future cash flows (undiscounted and without interest charges) from the asset. The impairment is measured as the amount by which the carrying amount exceeds the fair value of the asset. After an impairment is recognized, the reduced carrying amount of the asset should be accounted for as the new cost of the asset and depreciated over the remaining useful life (for depreciable assets). Restoration of previously recognized impairment losses is prohibited.

Real Estate to Be Disposed Of. All real estate to be disposed of that is not subject to the provisions of Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (FASB, *Current Text,* vol. 1, sec. I13), for which management, having the authority to approve the action, has committed to a plan of disposal, should be reported at the lower of carrying amount or fair value less costs to sell. Subsequent revisions to fair value less costs to sell should be reported as adjustments to the carrying amount of the asset to be disposed of. However, the carrying amount may not be adjusted to an amount greater than the carrying amount of the asset before an adjustment was made to reflect the decision to dispose of the asset. Determination of whether the carrying amounts of real estate projects require writedowns should be done on a project-by-project basis, in accordance with paragraph 24 of FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects* (FASB, *Current Text*, vol. 2, sec. Re2), as amended by FASB Statement No. 121.

In assessing the valuation of assets to be disposed of, auditors should consider various issues, including the following:

- Has management committed to the plan of disposal? Was the commitment made by management with the authority to approve the action?
- Has fair value been determined using reasonable assumptions and estimates?
- Has the client included appropriate costs in the estimate of costs to sell? Have the costs to sell been discounted, if appropriate?

In deliberating FASB Statement No. 121, the FASB decided not to provide an exception for assets subject to nonrecourse debt. The FASB considers the recognition of an impairment loss and the recognition of gain on extinguishment of debt to be two separate events.

Foreclosed Real Estate

SOP 92-3, *Accounting for Foreclosed Assets*, provides guidance on measuring foreclosed assets after foreclosure. Under SOP 92-3, there is a rebuttable presumption that foreclosed assets are held for sale. The SOP requires foreclosed assets held for sale to be carried at the lower of fair value minus estimated costs to sell or cost. Foreclosed assets held for the production of income should be treated the same way they would be had they been acquired in a manner other than foreclosure.

Auditors should be aware that some believe that the "held for sale" presumption of SOP 92-3 has been effectively superseded by FASB Statement No. 121. The FASB has added a project to its agenda to address certain provisions of FASB Statement No. 121. It is possible that, as a result of this project, that interpretation could be formalized.

SOP 92-3 refers to FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FASB, *Current Text*, vol. 1, sec. D22), for its definition of fair value. In considering the appropriateness of fair values, auditors of publicly held entities should consider the guidance in Section 401.09d of the SEC's *Codification of Financial Report-*

ing Policies, which indicates that the mere adoption of strategies such as hold-for-the-future strategy based on expectations of future price increases, or a strategy of operating repossessed collateral on one's own behalf, cannot justify the use of derived accounting valuations that portray the results of operations more favorably than would the use of current values in active markets.

Revenue Recognition

As discussed in the "Tax Matters" section of this Audit Risk Alert, certain real estate transactions are structured to achieve a desired result. Auditors should analyze such creative funding deals to ensure that their clients have accounted for the transaction properly.

The persistent feeling that the industry is on the verge of a recovery may lead to clients forecasting improvements in financial results that may not fully materialize. Auditors should consider the appropriateness of their clients' revenue-recognition policies, or changes therein. A number of clients may view the continued optimism within the industry as an opportunity to present improved financial results through changes in operating or accounting policies that affect the timing or propriety of revenue recognition. In evaluating the revenue recognition policies of real estate industry clients, auditors should consider carefully whether the criteria set forth in FASB Statement No. 66, *Accounting for Sales of Real Estate* (FASB *Current Text,* vol. 1, sec. R10), have been met. Auditors should consider the facts and circumstances surrounding property sales carefully to be certain that there are no formal or informal "put" arrangements committing the seller, its officers, or its shareholders to repurchase the property, find other buyers, or indemnify the buyer or third-party guarantors for risk of loss. Auditors should also consider circumstances that would indicate that a seller may have directly or indirectly provided the funds for a down payment (or for the entire purchase price) in a cash sale. Apart from precluding the use of the full accrual method of profit recognition, such circumstances may create relationships that meet the definition of related parties as set forth in FASB Statement No. 57, *Related Party Disclosures* (FASB, *Current Text,* vol. 1, sec. R36). SAS No. 45 describes procedures that are designed to determine the existence of related parties as defined by FASB Statement No. 57.

Availability of Funding

Real estate entities require substantial amounts of capital. Although lending activity appears to be on the rise, it is not at the level of the 1980s. As a result of the prolonged slump in the industry, and losses incurred in recent years, a number of the traditional sources of capital for the industry are no longer lending in the amounts they did previously. Financial institutions have become more selective in their real estate lending, a tendency that is attributable partly to recent losses, as well as to increased regulatory scrutiny. Moreover, sluggish global economic conditions have kept foreign investors from becoming an alternative source of funds.

SAS No. 59 describes an auditor's obligation to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. SAS No. 59 includes the "need to seek new sources or methods of financing" as an example of a condition or event that indicates there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable amount of time.

Deferred Rents

FASB Statement No. 13, *Accounting for Leases* (FASB, *Current Text,* vol. 1, sec. L10), requires that rents be recognized on a straight-line basis over the term of the lease even if payments are not made on a straight-line basis. Because of the number and magnitude of rent abatements and concessions being offered, significant deferred rent balances are sometimes recorded. In auditing such balances, auditors should consider carefully the reasonableness of assertions by management concerning the ability of tenants to perform according to the lease agreement. If tenants are unable to perform according to the lease agreement, deferred rents may not be fully recoverable.

Environmental Issues

The U.S. Environmental Protection Agency (EPA) is empowered by law to order any party that owned or operated a site currently included on the National Priorities List, or anyone who has arranged for disposal or transported hazardous materials to such a site, to remediate the site or to reimburse the EPA for remediation costs and pay additional damages. In many states, state agencies have powers similar to the EPA's with respect to contaminated sites. In view of the liabilities that may be incurred from owning contaminated sites, virtually all entities entering into real estate transactions today consider potential environmental liabilities. Auditors of real estate entities that face such claims should evaluate carefully whether the accounting and disclosure requirements of FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text,* vol. 1, sec. C59), have been met. As discussed in the "Accounting Developments" section of this Audit Risk Alert, in October 1996 the AICPA issued SOP 96-1, *Environmental Remediation Liabilities*. This SOP includes benchmarks to aid in the determination of when environmental remediation liabilities should be recognized in accordance with FASB Statement No. 5. It also provides guidance on the display of environmental remediation liabilities in financial statements and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations.

Auditors also should be aware of the consensuses reached in EITF Issues No. 93-5, *Accounting for Environmental Liabilities*, and 95-23, *The Treatment of Certain Site Restoration/Environmental Exit Costs When Testing a Long-Lived Asset for Impairment*. In EITF Issue No. 93-5, the EITF reached a consensus that an environmental liability should be evaluated independently from any potential recovery, and that the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable of realization. In EITF Issue No. 95-23, the EITF reached a consensus that future cash flows for environmental costs that are associated with a long-lived asset should be excluded from the undiscounted expected future cash flows used to test the asset for recoverability under FASB Statement No. 121. For environmental costs that have not been recognized as a liability for accounting purposes, the EITF reached a consensus that whether environmental exit costs should be in the undiscounted expected future cash flows used to test a long-lived asset for recoverability under FASB Statement No. 121 depends on management's intent with respect to the asset. The EITF Issue provides examples of management's intent and the corresponding treatment of the environmental exit costs in the FASB Statement No. 121 recoverability test.

Auditors of publicly held companies should also consider the requirements of the Securities Exchange Commission (SEC) Staff Accounting Bulletin (SAB) Topic 92, *Accounting and Disclosures Relating to Loss Contingencies*, which provides the SEC staff's interpretation of current literature related to accounting for environmental issues.

For further discussion, see *Audit Risk Alert—1996/97*.

Real Estate Investment Trusts

As discussed previously, the number of REIT offerings proliferated in the early 1990s. Beginning with the second half of 1994, however, interest rates began to rise. This resulted in an increased cost of capital for REITs, which was not necessarily offset by corresponding increases in the returns from properties owned. REIT share prices experienced a downturn, and initial public offering (IPO) activity decreased markedly, to only seven IPOs in 1995. REIT activity has increased again in 1996, although the level of activity is nowhere near the level of 1993 and 1994.

REITs require new capital to fund acquisitions for growth. Other than IPOs, REITs have been implementing several other methods of raising capital, each of which presents issues that an auditor should be aware of.

Secondary Public Offerings. In 1995, secondary offerings far exceeded IPO activity. Although there have been recent successes in the secondary-public-offering marketplace, this avenue is more likely to be open only for REITs with highly successful past operating results. Those REITs that have not been as successful will be forced to pay higher underwriting costs and incentives to purchasers of the stock. The increased cost of capital, without a corresponding increase in return from the properties, results in decreased yields and cash flows.

Auditors should be aware of the competition involved for secondary-public-offering money. As REITs compete for this money, trusts may overvalue assets in order to increase their desirability to investors. Auditors should obtain reasonable assurance that the valuations of the assets and liabilities are reasonable.

Bond Financings. In 1995, REITs were active in the bond market. Publicly rated debt sometimes can be issued more cheaply than equity. To the extent a REIT stock is considered undervalued, public debt is a more cost-effective method of raising capital. The relatively low weighted average cost of capital permits REITs to purchase real estate at low yields without diluting earnings. The achievement of an investment grade rating has made this an attractive method of capital formation for several REITs.

Mergers and Acquisitions. The increased cost of capital to REITs, combined with the fact that the majority of property previously owned by the Resolution Trust Corporation (RTC) has now been purchased, has made it more difficult for REITs to acquire properties at yields that substantially exceed a REIT's cost of capital. Additionally, a number of REITs have not met expectations that had been included in their offering materials. These factors serve to reduce the stock price of affected REITs, which in turn may make them acquisition candidates.

Auditors of REITs that may be acquisition candidates, such as those discussed above, should be aware of the possibility that trusts may overvalue assets in order to maintain a stock price at a level that would make them attractive to investors, but less attractive to potential acquiring entities. Auditors of larger, more successful REITs that may be looking to acquire other REITs also should be aware of this possibility.

Formation of Umbrella-Partnership Real Estate Investment Trusts. As a result of the downturn in IPO activity, many property owners found themselves unable or unwilling to proceed with planned IPOs. Many of these property owners are faced with "bullet" loans now coming due. These property owners may wish to consider the alternative of forming an UPREIT. Formation of an UPREIT is discussed in the "Tax Matters" section of this Audit Risk Alert. Also, for reasons discussed below, a traditional REIT may wish to convert itself to an UPREIT in order to place itself in an advantageous position for future property acquisitions.

The accounting issue discussed in EITF Issue No. 94-2, *Treatment of Minority Interests in Certain Real Estate Investment Trusts,* involves the question of how, and at what amount, the sponsor's minority interest should be reported in the REIT's consolidated financial statements. The EITF reached a consensus that the sponsor's interest in the operating partnership should be reported as a minority interest. As discussed in the "Accounting Developments" section of this Audit Risk Alert, in EITF Issue No. 95-7, *Implementation Issues Related to the Treatment of Minority Interests in Certain Real Estate Investment Trusts,* the EITF discussed certain issues related to minority interests in REITs.

Auditors of REITs should be aware of the requirements of SEC SAB Topic 97, and the relationship between SAB Topic 97 and EITF Issue No. 94-2.

When property owners look to sell their properties on a tax-deferred basis, an UPREIT can acquire the property in question by exchanging limited partnership units for it, thus postponing the taxable gain that the seller would have been required to recognize had it sold the property.

Formation of a DownREIT. As discussed in the "Tax Matters" section of this Audit Risk Alert, a DownREIT is a joint venture formed by an existing REIT with the owners of the desired acquisition property. All current properties continue to be held directly by the REIT. The REIT generally is the general partner of the joint venture.

Auditors should be aware of several disadvantages of the DownREIT structure. First, the structure may not provide for central ownership of all the REIT's properties. Future property acquisitions may become cumbersome. Also, the lack of central ownership may increase the administrative burden of managing and recordkeeping for the REIT properties. Auditors also should determine that the acquired property's cash flow and taxable income is not blended with those of the other REIT properties. Additionally, the DownREIT structure gives rise to potentially significant issues related to gain recognition, new basis, and consolidation. Finally, because of the complexity of the DownREIT structure, financial statement disclosures should be reviewed carefully.

Liquidity and Cash Flow Information

The SEC staff has noted that SEC registrants are expected to use the statement of cash flows and other appropriate indicators in analyzing their liquidity, and to present a balanced discussion in the Management's Discussion and Analysis (MD&A) section of SEC filings that addresses the cash flows from investing and financing activities, as well as from operations. A discussion of cash flow from operations by itself is not considered an appropriate presentation. If cash flow information is included in the Selected Financial Data section of SEC filings, it also should be presented in a balanced manner, including cash flows from operations, investing, and financing activities. The SEC staff also has indicated that, in the context of amounts available for distributions, it is more appropriate to discuss "cash available for distribution" than cash flow from operations, since distributions will be paid from available cash. SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 550), requires that auditors read such information and consider whether the information, or the manner of its presentation, is materially inconsistent with that appearing in the financial statements.

Non-GAAP Measures of Performance

The SEC staff has noted that publicly held real estate entities increasingly have been presenting "operating income before depreciation and amortization and writedowns of real estate" or, in some cases, "funds from operations" in Selected Financial Data and MD&A. The SEC staff believes that such captions in financial statements themselves are inappropriate because they suggest that the amount represents cash flow for the period, which is rarely the case. Cash flow from operations is the appropriate financial statement caption, which must be included in a balanced presentation with cash flows from investing and financing activities when discussing cash flows in MD&A and elsewhere. Auditors of public entities should read such information and consider whether the information, or the manner of its presentation, is materially inconsistent with that appearing in the financial statements.

The SEC staff has noted that funds from operations (FFO) has been discussed outside of the financial statements in several recent filings with the SEC. Neither GAAP nor the authoritative accounting literature provides a definition for FFO, and the SEC staff's view with respect to the presentation of a cash flow measure as a proxy for net income and the presentation of Funds Generated from Operations is expressed in Accounting Series Release (ASR) 142. ASR 142 states that if such measurements of economic performance are presented in the MD&A section or elsewhere, they should not be presented in a manner that gives them greater authority or prominence than conventionally computed earnings. In no event should the presentation leave the reader with the impression that FFO is the appropriate measure of operating performance for the REIT and an appropriate measure for which dividends are computed and based. Net income and cash flows from operating, investing, and financing activities remain the appropriate measurements.

Investments in Derivatives

Interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments derive their value have increased in volatility over the past several months. As a result, a number of entities have incurred significant losses attributable to the use of derivatives. Entities in the real estate industry sometimes use such instruments as risk management tools (hedges) or as speculative investment vehicles. Derivatives nearly always increase audit risk. Although the financial statement assertions about transactions involving derivatives are generally similar to assertions about other transactions, the auditor's approach to achieving related audit objectives may differ because certain derivatives, such as forward contracts, swaps, options, and other financial instruments with similar characteristics, generally are not recognized in the financial statements. Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in Audit Risk Alert—1996. In addition, auditors may wish to refer to the SEC's proposal on comprehensive disclosure requirements for derivatives and other financial instruments, issued for public comment in early 1996. The SEC anticipates issuance of a final staff bulletin on this topic by December 31, 1996.

Auditing Pronouncements

As summarized in the following Exhibit, five new SASs, which are discussed below, have been issued recently.

Exhibit

Significant Provisions of Newly Issued SASs

Pronouncement	*Pronouncements Affected*	*Key Provisions*
SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*	SAS No. 35	Prohibits negative assurance. Provides guidance concerning the conditions for performing agreed-upon procedures engagements; the nature, timing, and extent of the procedures; the responsibilities of practitioners and specified users; and reporting on agreed-upon procedures.
SAS No. 76, *Amendments to SAS No. 72,* Letters for Underwriters and Certain Other Requesting Parties	SAS No. 72	Specifies the form of letter to be provided by the accountant in circumstances in which a comfort letter is requested but the requesting party has not provided a representation letter.
SAS No. 77, *Amendments to SAS No. 22,* Planning and Supervision, *No. 59,* The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, *and No. 62,* Special Reports	SAS Nos. 22, 59, and 62	Clarifies that a written audit program should be prepared. Precludes the use of conditional language in a going concern report.
SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*	SAS No. 55	Recognizes the COSO definition of internal control.
SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements	SAS No. 58	Eliminates the requirement to add an uncertainties paragraph to the auditor's report (does not affect SAS No. 59).

SAS No. 75. In September 1995, the AICPA issued SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, AU sec. 622), which provides guidance to an accountant concerning performance and reporting in all engagements to apply agreed-upon procedures to specified elements, accounts, or items of a financial statement, except in certain circumstances, as discussed in the SAS. The Statement is effective for reports on engagements to apply agreed-upon procedures dated after April 30, 1996, with earlier application encouraged.

SAS No. 76. In September 1995, the AICPA issued SAS No. 76, *Amendments to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634 and AT sec. 300). The SAS provides reporting guidance and an example of a letter, actually a form of agreed-upon procedures report, that the accountant can provide in response to a request to provide a comfort letter in circumstances in which the party requesting the letter is not willing to provide the accountant with the representations required in paragraph 6 of SAS No. 72. SAS No. 76 is effective for letters issued pursuant to paragraph 9 of SAS No. 72 after April 30, 1996.

SAS No. 77. In November 1995, the AICPA issued SAS No. 77 which, among other things, clarifies that a written audit program should be prepared in every audit and precludes the use of conditional language in the auditor's explanatory paragraph to indicate that there is substantial doubt about the entity's ability to continue as a going concern. SAS No. 77 is effective for engagements beginning after December 15, 1995.

SAS No. 78. In December 1995, the AICPA issued SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55* (AICPA, *Professional Standards*, vol. 1, sec. 319), which revises the definition and description of internal control contained in the Statements on Auditing Standards to recognize the definition and description contained in Internal Control—Integrated Framework (the COSO Report), published by the Committee of Sponsoring Organizations of the Treadway Commission, formed to address the Report of the National Commission on Fraudulent Financial Reporting. This Statement is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

SAS No. 79. In December 1995, the AICPA issued SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements (AICPA, *Professional Standards,* vol. 1, AU sec. 508), which eliminates the requirement that, when certain criteria are met, the auditor add an uncertainties explanatory paragraph to the auditor's report. SAS No. 79 also clarifies and reorganizes the guidance in SAS No. 58 concerning emphasis paragraphs, matters involving uncertainties, and disclaimers of opinion. SAS 79 does not affect SAS No. 59 nor does it preclude the auditor from adding a paragraph to the auditor's report to emphasize a matter disclosed in the financial statements.

As discussed in SAS No. 79, a matter involving an uncertainty is one that is expected to be resolved at a future date, at which time conclusive evidential matter concerning its outcome would be expected to become available. Uncertainties include, but are not limited to, contingencies covered by FASB Statement No. 5 and matters related to estimates covered by SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with GAAP, based on management's analysis of existing conditions. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertion about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate. If the auditor is unable to obtain sufficient evidential matter to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. A qualification or disclaimer of opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management.

SAS No. 79 is effective for reports issued or reissued on or after February 29, 1996, with earlier application permitted.

SAS No. 80. In December 1996, the AICPA issued a new SAS, *Amendment to SAS No. 31,* Evidential Matter (AICPA, *Professional Standards,* vol. 1, sec. 326), which is effective for engagements beginning on or after January 1, 1997. This Statement provides guidance for a practitioner who has been engaged to audit an entity's financial statements where significant information is transmitted, processed, maintained, or accessed electronically. The new Statement includes examples of evidential matter in electronic form and provide that an auditor should consider the time during which such evidential matter exists or is available in determining the nature, timing, and extent of substantive tests. In addition, the Statement indicates that an auditor may determine that, in certain entities when evidential matter is in electronic form, it would not be practical or possible to reduce detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. The Statement provides that in such circumstances, an auditor should perform tests of controls to support an assessed level of control risk below the maximum for affected assertions. Evidence provided by these tests of controls, when combined with that provided by substantive tests, should be sufficient to support the auditor's opinion to be issued.

Additionally, at the time of this writing, an exposure draft of the following proposed SAS was outstanding.

Consideration of Fraud in a Financial Statement Audit. In May 1996 the AICPA issued an exposure draft of a proposed Statement on Auditing Standards, *Consideration of Fraud in a Financial Statement Audit and Amendments to Statements on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures, *and No. 47,* Audit Risk and Materiality in Conducting and Audit. The proposed Statement would provide expanded operational guidance on the consideration of fraud in conducting a financial statement audit. The proposed changes in auditing standards also clarify the auditor's present responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether caused by error or fraud. In addition, the proposed changes provide added guidance on the standard of due professional care in the performance of work, including the need to exercise professional skepticism, and the concept of reasonable assurance. In addition to amending SAS Nos. 1 and 47, the proposed Statement would—

- Describe fraud and its characteristics.
- Require the auditor to specifically assess the risk of material misstatement due to fraud and provide categories of fraud risk factors that should be considered in the auditor's assessment.

- Provide guidance on how the auditor should respond to the results of the assessment.
- Provide guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud.
- Describe related documentation requirements.
- Provide guidance regarding the auditor's communication about fraud to management, the audit committee, and others.

Accounting Developments

FASB Statement on Impairment

In March 1995, the FASB issued FASB Statement No. 121. As discussed previously, FASB Statement No. 121 has particular importance to the real estate industry. FASB Statement No. 121 requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or circumstances indicate that their carrying amounts may not be recoverable. In performing the review for impairment, the entity should estimate the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss is recognized. Measurement of an impairment loss for long-lived assets and identifiable intangibles that an entity expects to hold and use should be based on the fair value of the asset.

The Statement requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying value or fair value less cost to sell, except for those assets that are covered by APB Opinion 30.

It also amends FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects* (FASB, *Current Text*, vol. 2, sec. Re 2), by requiring that "a real estate project, or parts thereof, that is substantially complete and ready for its intended use shall be accounted for at the lower of carrying amount or fair value less costs to sell." Under FASB Statement No. 67, such real estate projects were accounted for at the lower of cost or net realizable value. Projects under development and land to be developed are considered assets to be held and used.

The Statement is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged.

FASB Statement on Transfers and Servicing of Financial Assets and Extinguishment of Liabilities

In June 1996, the FASB issued Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities.* This Statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishment of liabilities. Those standards are based on consistent application of a financial-components approach that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. This Statement provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interest in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

1. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
2. Either (*a*) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right—to pledge or exchange the transferred assets or (*b*) the transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right—to pledge or exchange those interests.
3. The transferor does not maintain effective control over the transferred assets through (*a*) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (*b*) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

FASB Statement No. 125 requires that liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also requires that servicing assets and other retained interest in transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

FASB Statement No. 125 requires that servicing assets and liabilities be subsequently measured by (1) amortization in proportion to and over the period of estimated net servicing income or loss and (2) assessment for asset impairment or increased obligation based on their fair values.

FASB Statement No. 125 requires that debtors reclassify financial assets pledged as collateral and that secured parties recognize those assets and their obligation to return them in certain circumstances in which the secured party has taken control of those assets.

FASB Statement No. 125 requires that a liability be derecognized if and only if either (1) the debtor pays the creditor and is relieved of its obligation for the liability or (2) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

FASB Statement No. 125 provides implementation guidance for assessing isolation of transferred assets and for accounting for transfers of partial interest, servicing of financial assets, securitizations, transfers of sales-type and direct financial lease receivables, securities lending transactions, repurchase agreements including "dollar rolls," "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishment of liabilities.

FASB Statement No. 125 supersedes FASB Statements No. 76, *Extinguishment of Debt* (FASB, *Current Text,* vol. 1, sec. D14), and No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse* (FASB, *Current Text,* vol. 1, sec. I80). This Statement amends FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* to clarify that a debt security may not be classified as held-to-maturity if it can be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. This Statement amends and extends to all servicing assets and liabilities the accounting standards for mortgage servicing rights now in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (FASB, *Current Text,* vol. 2, sec. Mo4), and supersedes FASB Statement No. 122, *Accounting for Mortgage Servicing Rights* (FASB, *Current Text,* vol. 2, sec. Mo4). This Statement also supersedes FASB Technical Bulletins No. 84-4, *In-Substance Defeasance of Debt* (FASB, *Current Text,* vol. 1, sec. D14), No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)* (FASB, *Current Text,* vol. 1, sec. C30) and No. 87-3, *Accounting for Mortgage Servicing Fees and Rights* (FASB, *Current Text,* vol. 21, sec. Mo4).

FASB Statement No. 125 is effective for transfers and servicing of financial assets and extinguishment of liabilities occurring after December 31, 1996, and is to be applied prospectively. Earlier or retroactive application is not permitted.

Stock-Based Compensation

In October 1995, the FASB issued Statement No. 123, *Accounting for Stock-Based Compensation* (FASB, *Current Text,* vol. 1, sec. C36), which establishes financial accounting for stock-based employee compensation plans. The Statement encourages companies to account for stock compensation awards using a fair value method. Fair value is determined based on the stock price at the date the awards are granted. The resulting compensation cost would be recognized as an expense in the income statement over the service period. FASB Statement No. 123 also applies to equity instruments issued for goods or services provided by persons other than employees. The accounting requirements of this Statement are effective for transactions entered into in fiscal years that begin after December 15, 1995, though they may be adopted on issuance.

FASB Statement on Derivatives

FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25), issued in October 1994, was effective for financial statements issued for fiscal years ending after December 15, 1994. However, for entities with less than $150 million in total assets as of that date, the effective date was extended to fiscal years ending after December 15, 1995.

FASB Statement No. 119 requires disclosures about derivative financial instruments futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text,* vol. 1, sec. F25) to require disaggregation of information about financial instruments with off-balance-sheet risk of accounting loss by class, business activity, risk, or other category that is consistent with the entity's management of those instruments. The Statement also amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25), to require that fair value information be presented without combining, aggregating, or netting the fair value of derivative financial instruments with the fair value of nonderivative financial instruments and that it be presented together with the related carrying amounts in the body of the financial statements, a single footnote, or a summary table in a form that makes it clear whether the amounts represent assets or liabilities.

Auditors should consider whether the provisions of FASB Statement 119 apply to their clients, and if so, evaluate whether the client's financial statement disclosures are adequate and appropriate in view of the requirements set forth therein. Also, as discussed in the "Audit Issues and Developments" section of this Audit Risk Alert, auditors should be aware that the SEC anticipates that a final staff accounting bulletin will be issued by December 31, 1996 on the topic of comprehensive disclosure requirements for derivatives and other financial instruments.

FASB Statement on Disclosures about Fair Value of Financial Instruments

FASB Statement No. 107 was effective for financial statements issued for fiscal years ending after December 15, 1992. However, for entities with less than $150 million in total assets as of that date, the effective date was extended to fiscal years ending after December 15, 1995. For those real estate entities with less than $150 million in total assets as of December 15, 1992, financial statements for years ended during 1996 will be subject to the provisions of FASB Statement No. 107. In such circumstances, auditors should consider whether management has made all disclosures required by FASB Statement No. 107.

FASB Statement No. 107 requires disclosure of the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. If estimating fair value is not practicable, the Statement requires disclosure of descriptive information pertinent to estimating the value of a financial instrument. Certain financial instruments (for example, lease contracts, deferred-compensation arrangements, and insurance contracts) are excluded from the scope of the Statement.

Auditors should be aware that in September 1996, the FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Elimination of Certain Disclosures about Financial Instruments by Small Nonpublic Entities—an Amendment of FASB Statement No. 107*. This proposed Statement would make the disclosures about the fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria:

1. The entity is a nonpublic entity.
2. The entity's total assets are less than $10 million on the date of the financial statements.

3. The entity has not held or issued any derivative financial instruments as defined in FASB Statement No. 119 during the reporting period.

The proposed Statement would be effective upon issuance. The FASB expects to issue a final Statement in the fourth quarter of 1996.

Emerging Issues Task Force Issues

The EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to real estate enterprises. A description of issues discussed since the release of *Audit Risk Alert—Real Estate Industry Developments 1995/96* follows; readers should consult detailed minutes for additional information.

In EITF Issue No. 95-6, *Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation,* the EITF reached a consensus that, regardless of the method of accounting used by a REIT for its investment in a service corporation, the service corporation should not be considered an independent third party and the costs capitalized by the REIT for leasing services provided by the service corporation should be no greater than the amount of costs that would have been capitalized under FASB Statement No. 13, as amended by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with originating or Acquiring Leases and Initial Direct Costs of Leases* (FASB, *Current Text,* vol. 1, sec. L20) had the REIT incurred the costs directly.

The EITF also reached a consensus that the existence of certain factors (listed in the EITF Abstract) indicate the REIT has the ability to exercise at least significant influence over the service corporation and that, accordingly, the REIT should not account for its investment in the service corporation using the cost method.

In EITF Issue No. 95-7, the EITF reached a consensus that although a minority interest balance may be negative, the minority interest charge in the REIT's consolidated income statement should be the greater of (1) the minority interest holder's share of the operating partnership's earnings for the year (if any) or (2) the amount of distributions to the minority interest holder during the year. Any amount by which (1) exceeds (2) for the year should be credited directly to the REIT's equity (with a corresponding debit to minority interest) until the minority interest deficit that existed at the formation of the REIT is eliminated. If the minority interest deficit increases after the formation (for example, due to operating partnership distributions in excess of earnings) and then is reduced (but still is greater than the deficit at formation), the reduction should first be credited to the majority interest to the extent of minority interest losses and distributions previously absorbed through earnings by the majority interest.

The EITF also reached a consensus that the REIT should account for any subsequent acquisitions of the sponsor's minority interest in the operating partnership for cash in a manner that is consistent with the accounting for the formation of the REIT. This second consensus is applicable only to REITs with operating structures described in the Issue and Issue No. 94-2.

AICPA Statement of Position 94-6 on Disclosure of Certain Significant Risks and Uncertainties

In December 1994, the AICPA issued SOP 94-6. The SOP is effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which the SOP is first applied. The SOP requires reporting entities to include in their financial statements disclosures about the nature of their operations and the use of estimates in the preparation of the financial statements. If specified disclosure criteria are met, the SOP requires entities to also include in their financial statements disclosures about certain significant estimates and current vulnerabilities due to certain concentrations.

Paragraph 18 of SOP 94-6 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Examples of estimates that may be included in the financial statements of real estate enterprises are:

- Impairment of long-lived assets
- Estimates of environmental remediation liabilities
- Profit recognition on sales recognized on the installment method

Examples of concentrations that may be subject to disclosure in the financial statements of real estate enterprises may include the following:

- Ownership of numerous properties within one geographical area
- Financial results reliant on a single lessee
- Funding commitments from one financial institution related to project development

Auditors should be alert to the requirements of this new SOP and its impact upon the financial statement disclosures of the entity being audited. Auditors should consider carefully whether all significant estimates and concentrations have been identified and considered for disclosure.

AICPA Statement of Position 96-1 on Environmental Remediation Liabilities

In October, 1996, the AICPA issued SOP 96-1. This SOP provides—

- That environmental remediation liabilities should be accrued when the criteria of FASB Statement No. 5 are met, and it includes benchmarks to aid in the determination of when environmental remediation liabilities should be recognized in accordance with FASB Statement No. 5.
- That an accrual for environmental liabilities should include—
  - Incremental direct costs of the remediation effort, as defined.
  - Costs of compensation and benefits for those employees who are expected to devote a significant amount of time directly to the remediation effort, to the extent of the time expected to be spent directly on the remediation effort.
- That the measurement of the liability should include—
  - The entity's allocable share of the liability for a specific site.
  - The entity's share of amounts related to the site that will not be paid by other potentially responsible parties or the government.
- That the measurement of the liability should be based on enacted laws and existing regulations and policies, and on the remediation technology that is expected to be approved to complete the remediation effort.
- That the measurement of the liability should be based on the reporting entity's estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed and that the measurement may be discounted to reflect the time value of money if the aggregate amount of the liability or the component of the liability and the amount and timing of cash payments for the liability or component are fixed or reliably determinable.
- Guidance on the display of environmental remediation liabilities in financial statements and on disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies, and other loss contingency disclosure considerations.

The provisions of SOP 96-1 are effective for fiscal years beginning after December 15, 1996. Earlier application is encouraged. The effect of initially applying the SOP should be reported as a change in accounting estimate. Restatement of previously issued financial statements is not permitted.

Accounting Standards Executive Committee Conforming Changes

In March 1996, the Accounting Standards Executive Committee (AcSEC) of the AICPA updated its technical guidance to conform certain SOPs and Practice Bulletins with pronouncements issued recently by the FASB. AcSEC made conforming changes to the following SOPs and Practice Bulletins:

- SOP 75-2 and SOP 78-2, both entitled *Accounting Practices of Real Estate Investment Trusts*
- SOP 78-9, *Accounting for Investments in Real Estate Ventures*
- SOP 90-11, *Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets*
- SOP 93-6, *Employers' Accounting for Employee Stock Ownership Plans*
- Practice Bulletin 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance,* Exhibit F, Accounting and Disclosure for Reinsurance Transactions
- Practice Bulletin 9, *Disclosures of Fronting Arrangements by Fronting Companies*

Auditors should be aware of these changes.

Information Sources

Further information matters addressed in this risk alert is available through various publications and services listed in the table at the end of this document. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols. In 1996 many organizations have established Web Sites on the world wide web.

Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (extension 3) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748. WebSite: http://www.aicpa.org	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 *(203) 847-0700, ext. 10*		WebSite: http://www.fasb.org	*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250 (f)		*U.S. Government Printing Office's The Federal Bulletin Board* Includes *Federal Register* notices and the Code of Federal Regulations. Users are usually expected to open a deposit account. User assistance line: (202) 512-1530 (202) 512-1387 (d) Telnet via internet: federal.bbs.gpo.gov 3001	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8090	*Information Line* (202) 942-8088, ext. 4 (202) 942-7114 (tty)	WebSite: http://www.sec.gov	*Information Line* (202) 942-8088 (202) 942-7114 (tty)

022197